

COMMONWEALTH OF MASSACHUSETTS

PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION COMMISSION

Reform Initiatives

Advisory Committee Report

2005

Commission Members

- The Honorable Domenic J. F. Russo
Chairman
- The Honorable A. Joseph DeNucci
Auditor of the Commonwealth
Vice Chairman
- Henry G. Brauer
Investment Professional
- Kenneth J. Donnelly
Lieutenant
Lexington Fire Department
- Eric Kriss
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LETTER FROM THE COMMISSION

PERAC Reform Initiatives Advisory Committee

Scott Harshbarger, *Chair*

Cary Coglianese

Paul M. Healy

Alan G. Macdonald

Jerrold Mitchell

Dear Chairman Harshbarger and Members:

On behalf of the Public Employee Retirement Administration Commission and staff, and indirectly the citizens of the Commonwealth Massachusetts, we would like to thank you for your diligent efforts in reviewing and making recommendations on PERAC's pension reform discussion items.

As you know, last fall the Commission embarked upon an examination of the nearly 8-year history of PERAC's oversight of the 106 retirement systems in Massachusetts. This was done with an eye to the past—and a vision toward the future. We identified critical issue areas in our oversight functions that we felt were appropriate for a thorough and impartial review. We also examined instances where a lack of clear or more focused authority had hindered the agency's ability to carry out its statutory mission.

The Commission can clearly state that our objective in this initiative was not to seek an easy mechanism to order systems into the PRIT fund or to in any way disrupt the ability of well-managed systems to carry out their fiduciary responsibilities. Rather, the Commission felt that strengthening the agency's oversight capabilities would help preserve the independence of the systems, further safeguard system assets, and ultimately provide a stronger guarantee of benefits for retirees. Hence, we concluded that a prudent review of these issues was not only warranted but as Chairman Harshbarger stated, "not to do so would be a failure of responsibility."

To accomplish our goals, the Commission concluded that a thorough, thoughtful


and, importantly, a dispassionate examination by outside experts in the field of governance and public administration was both prudent and warranted. Your Committee accepted this mission and undertook the assignment with great enthusiasm and dedication. You offered sound insight into the complex issues the Commission placed before you. In receiving updates from staff as the project progressed, in personally attending your meetings, and in the presentation of your report, Commission members were singularly impressed with the commitment you brought to this process.

We also sought and received excellent feedback from the Public Pension Advisory Group, a group of retirement board administrators from around the state, as well as additional representatives of retirement systems including the Massachusetts Association of Contributory Retirement Systems, the Massachusetts Retirees Association and others on our proposals. Their feedback contributed greatly to this process and we extend our appreciation to them as well.

There can be no greater demonstration of our appreciation for all of these efforts than in their result. On May 25, 2005 the Public Employee Retirement Administration Commission unanimously approved all of the recommendations contained in your report.

Again, please accept our sincere appreciation for a job well done, and we hope that you will continue to be available to us as we further advance these important issues and implement the Commission's strategy.

Sincerely,



Domenic J. F. Russo
Chairman



Joseph E. Connarton
Executive Director

INTRODUCTION

The Public Employee Retirement Administration Commission (PERAC) oversees retirement systems that are a product of nearly 100 years of statutory, regulatory, and administrative evolution. Until the years following World War II, retirement rights and benefits were administered through boards with little or no central supervision. The revision of Chapter 32 of the General Laws in 1945 altered the disparate nature of these systems and created a uniform statutory framework governing the rights and benefits available to public employees and their beneficiaries. Although this revision solved many of the inherent problems in the previous fragmented approach to public pensions, it failed to consider the long-range impact of provisions relating to the funding of pensions, the process for determining eligibility for disability and the need for regulatory oversight of more than 100 boards responsible for the administration of retirement systems.

In reality there is not **a single** public system in Massachusetts—there are 106 different systems. Each is independent with considerable responsibilities and powers. Typically a five-member board, comprised of appointed and elected members, manages each system. These board members are fiduciaries of the system, responsible for making determinations on members' eligibility for benefits, investing the often-considerable system assets and supervising the board staff.

The largest public systems are the State Retirement System for state employees, the Teachers' Retirement System for most municipal teachers, the Boston Retirement System for Boston employees, and the county and regional retirement systems for county employees and employees of smaller towns. This decentralized system guarantees that, with the exception of the Teachers' System, the employer bears responsibility for the financing of its employees' retirement costs. The sizes of the various systems vary tremendously. The State Retirement System has over 85,000 active members and over 40,000 retirees. The smallest system has fewer than 70 members and retirees. PERAC oversees all of these systems uniformly.

The statute governing the system has been amended on numerous occasions since 1945. Two major alterations occurred in 1987 and 1996, when revisions impacting the oversight and administration of the disability retirement systems were instituted.

In 1982, the predecessor of PERAC, the Public Employee Retirement Administration (PERA), was created to oversee the 106 systems. In 1996, Chapter 306 of the Acts of 1996 created PERAC (the Commission), to refine the oversight role for these systems.

A PRUDENT REVIEW

Recent events in the public and private sector have underscored the importance of ensuring that proper procedures are in place to avoid conflict of interest, self-dealing and inattention to detail among those responsible for managing important institutions. After 8 years in existence, the Commission determined that it is not only prudent but also necessary to review the agency's experience with an eye toward the future.

The resulting review centered on the Commission's ability to oversee the 106 retirement systems effectively and efficiently. While almost all boards and board members act with integrity and the intention to carry out their fiduciary responsibilities consistent with statute and good practice, a few risks threaten the entire system. Troubling recent situations have arisen and consumed significant PERAC staff time. Extensive Commission deliberations on these situations include:

- Failure of one system to submit statutorily-mandated Annual Financial Statements for a significant period of time;
- Attempts by one system to provide three separate benefits to a widow;
- Controversy regarding whether contractual agreements between the locality and unions are consistent with the definition of "regular compensation" in Section 1 of Chapter 32;
- Refusal by systems to properly pay benefits to members or to reinstate a member who was on the payroll but not officially accepted as a "member" of the system; and,
- Dealing with system investment losses.

These and other concerns formed the basis for the Commission's decision to institute the Advisory Committee. The good faith of the hundreds of dedicated board members in the systems who are doing their jobs well demands no less. It is incumbent upon PERAC to initiate this review to protect the systems and their assets. It is also clear to us that PERAC needs adequate tools to address these important issues.

THE ADVISORY COMMITTEE

In late 2004, the Commission established an Advisory Committee consisting of five governance experts from business and academia, with several possessing background in Massachusetts state government, to review the existing statutory and regulatory framework:

Scott Harshbarger, former Massachusetts Attorney General, former President and CEO of Common Cause, current Partner and head of the governance practice at Murphy, Hesse, Toomey & Lehane, LLP, who served as Chair.

Professor Cary Coglianesi, Chair of the Regulatory Policy Program and Associate Professor of Public Policy, John F. Kennedy School of Government at Harvard University;

Professor Paul M. Healy, James R. Williston Professor of Business Administration, Harvard Business School, Harvard University;

Alan G. Macdonald, Executive Director of the Massachusetts Business Roundtable, a former member of the Winchester Retirement Board, and former Massachusetts Assistant Attorney General; and,

Jerrold Mitchell, Chief Investment Officer at The Boston Foundation, and former Chief Investment Officer of the Pension Reserves Investment Management Board (PRIM).

The Advisory Committee began its deliberations on January 6, 2005 and met roughly monthly until it completed its deliberations on April 29, 2005. Committee members were selected as a small but diverse group of individuals experienced in governance or working on or with retirement systems. The Committee's charge was to focus on investments, enforcement, conflict of interest, board structure, education, and review the need for reform, assess various alternatives, and report to the Commission.

GENERAL CONCLUSIONS

The Advisory Committee, working with the assistance of PERAC staff and input from members of the Public Pension Advisory Group (PPAG) and various retirement board members, reached several general conclusions:

The Advisory Committee believes that the new realities of corporate governance make it appropriate and essential that PERAC engage periodically in this kind of independent review. Scandals in corporate governance have affected almost every major institution in our society, leading to an increased focus on accountability, transparency, disclosure, expertise, independence, and responsibility to constituents and shareholders to ensure integrity as well as performance. As the agency responsible for oversight and monitoring of local retirement boards, particularly with respect to the investment of funds and the administration of the systems, PERAC must periodically conduct a governance review and audit the strength and weaknesses of the current legal and statutory framework. This includes PERAC's own performance and that of those it is charged with overseeing. We note here that the state investment board—the Pension Reserves Investment Management Board (PRIM)—has, at the request of the Treasurer of the Commonwealth, already undertaken a similar governance review and, as a result, has adopted many governance reforms. These actions are to be commended and encouraged.

We believe that if PERAC did not conduct such a review, it would be failing in the responsibility of due diligence, governance, and oversight that it owes to the Legislature as well as to the members of the retirement systems. The recent exposure of major weaknesses in the system of checks and balances relating to institutions elsewhere in our nation has raised great concerns about the competence, independence, and performance of some of the professionals acting as fiduciaries and service providers to retirement boards. It is risky, if not irresponsible, to believe that the same negative patterns and practices that have occurred elsewhere could not exist in Massachusetts. PERAC's governance review by an independent group with wide-ranging expertise and experience is a model for other regulatory agencies. This kind of review (which should take place on a regular basis by all parties involved in the retirement systems) by PERAC is appropriate and necessary in fulfilling its regulatory responsibilities.

As will become clear in the comments, observations, and recommendations that we make, the Committee feels strongly that PERAC's commitment to best practices and education provides the most cost-effective approach to effecting any necessary changes in governance. Prevention is always the best and cheapest form of protection, and in this regard, we encourage PERAC to seek mandatory education of board members and implementation of best practices and governance principles for local boards. We believe that every board member should be required to have initial mandatory education and be subject to an ongoing, continuing certification process concerning their responsibilities as fiduciaries and trustees in the management of the retirement funds and in meeting the "prudent expert" standard. Similarly, best practices pertaining to all areas of board responsibility exist. Any board that is not applying these best practices to serve its own circumstances is not fulfilling its due diligence or fiduciary responsibilities.

There is also a critical need for PERAC to have unequivocal authority to impose appropriate discipline and sanctions on boards, as well as vendors and independent professionals operating within the system in egregious cases. That authority should be clarified and strengthened to ensure that there are teeth available to PERAC to enforce the law and its regulations.

We believe that if PERAC does not have authority to sanction or to act in appropriate cases, it cannot be held accountable for doing its job. In fact, one of the recent criticisms of regulatory agencies in the wake of a number of national cases of fraud and mismanagement has been that regulators have failed to fulfill their enforcement and oversight role. Yet, if regulatory agencies do not have clear authority, or if that authority can be and is repeatedly challenged, agencies have a tendency to become passive and overly cautious in their performance. If PERAC does not act in serious cases because it is not clear that it has the authority to act, no agency will be accountable for enforcement at the state level. It is our view that retirement boards ought to welcome the oversight of PERAC, because the Commission's staff and members understand the pressures boards face, and self-regulation with teeth is far preferable to external review and regulation by those who may have more power, but less expertise, and who must act because a vacuum has been created. Strengthening PERAC is the best way to seal off inexperienced review

and reforms that may not be in the best interest of retirement board members, their members, or the overall system.

We have chosen to focus in this report on issues that have been historically problematic as well as issues that are essential in terms of good corporate governance. We believe that all of our recommendations should be targeted for an effective date of approximately six to nine months after this report is finalized, adopted by PERAC, and passed into law, in order to facilitate education and training so that retirement board members understand what the changes will be and have an opportunity to adapt to them. To this end, we commend the suggestions of the PERAC staff that there be system-wide training, and we also commend the leaders of the state associations for agreeing to partner in that kind of education and dialogue.

The Committee's recommendations, if implemented, will serve not only to enable PERAC to perform its statutory function effectively, and to protect the integrity and financial performance of the public pension system under its purview, but will also protect members of retirement boards. As the recent corporate scandals show, financial improprieties by a small number of rogues can have very negative implications for the reputations of well-intentioned board members. By clarifying best practice, and providing for judicious overview of the systems where needed, our proposals will help protect the reputations and enhance the acknowledged integrity of retirement board members.

I would like to extend my thanks to the members of the Committee. I have taken great pleasure in getting to know and to work with them. The Commonwealth is well served by the willingness of these individuals to donate their time pro bono to this project. I have been impressed by the dedication and willingness of these individuals to give their time and expertise, subject only to scheduling conflicts. As their attached biographical information demonstrates, they are individuals who have many other options and choices about how they allocate their pro bono time and we are very grateful to them for all they have done. Our final recommendation is that PERAC adopt an annual or bi-annual review process by which a similar kind of review and self-evaluation is periodically undertaken.

We look forward to the comments of the Commission and others as we proceed in this venture. The Committee is willing to continue to play any role the Commission deems helpful in implementing our findings and recommendations.

For the Committee,

A handwritten signature in blue ink, appearing to read 'Scott Harshbarger', is written over the printed name.

Scott Harshbarger
Chair

COMMITTEE RECOMMENDATIONS

The Committee's recommendations fall into 5 areas:

1. Investment
2. Enforcement
3. Conflict of Interest
4. Board Structure
5. Best Practices Manual and Mandatory Education

In each of these areas, we provide a fairly succinct description of why this is an area of concern and recommendations as to how best to proceed in general terms—whether by legislation, regulation, advisory opinion and/or education—leaving the details of the actual language of the legislation or regulation for the Commission and PERAC staff, rather than trying to draft here by the Committee.

1. INVESTMENT

Repeal Investment Restrictions, Enhance Vendor Disclosure, Procurement Reform, and Proxy Voting

A. Repeal the Legal List Investment Restrictions

The retirement boards have invested assets pursuant to essentially the same process since 1985. Existing law provides that boards will invest the assets “in securities other than mortgages or collateral loans, which are legal for the investment of funds of savings banks under the laws of the Commonwealth;” however, those limits will not apply to “the board of any local retirement system which upon application is determined by the commission to have a record of investment management which merits broader powers.”

It is this language that resulted in PERA initially establishing a “waiver” process by which boards could receive a “waiver” from the Legal List limitations and thus invest according to regulations and the fiduciary standard set forth in Chapter 32, Section 23 (3). It is recommended that this process be eliminated.

The general thrust of current statutory investment authority focused on the transition from strict “legal list” investing to the “prudent expert” standard of modern investment management. Boards have now experienced almost 20 years of investing under the “prudent expert” standard and thus the general statutory scheme that limits their flexibility and imposes procedural complications should be reviewed.

The thrust of PERAC regulatory oversight should focus on the competitive process and conflict disclosure. Retirement boards are now sufficiently experienced to manage assets free of cumbersome and unnecessary procedures. At the same time adding certain requirements (Statutory Procurement Process, PERAC Disciplinary Authority, Annual Board Certification, Conflict Disclosures, and Limits on Board Membership) will assist boards in meeting their fiduciary duty.

Examples of Problems

- There have been cases of board confusion over who is responsible for filing exemption related forms, leading to delays in implementing investment decisions.
- The present exemption process is confusing, particularly to those seeking to enter the Massachusetts market, and as a result may deter participation of vendors in Massachusetts searches.

Recommendation

We recommend that in retaining a manager or investing in a trust/partnership the board would be required to submit to PERAC:

- a. A certification that, in making the selection, the board has employed a competitive process;
- b. Copy of the vendor certification of non-collusion;
- c. Copies of disclosure forms submitted by the selected vendor;
- d. A certification that the investment is not a prohibited investment as set forth in regulations of the Commission; and,
- e. A copy of the board certification of non-collusion.

PERAC would retain its authority to prohibit a particular investment if doing so is in the best interest of the system.

B. Repeal Specific Investment Restrictions

The statute establishes limits on investment in tobacco companies, investing in mortgages and collateral loans, investing in Northern Ireland and investing in South Africa.

Recommendation

We recommend that the statutory limits on investing in Northern Ireland and South Africa, which are difficult to enforce and no longer relevant, be repealed.

C. Enhanced Vendor Disclosure

Across the nation, regulators and the public increasingly scrutinize the role of consultants and other parties in the decision making process of pension funds. As noted in a *New York Times* article last year, a “small but growing part of the \$2 trillion in state and local pension funds is being steered into high-risk investments by pension consultants and others who often have business dealings with the very money managers they recommend.” In some cases, pension funds have lost investments and governments have needed to use revenues to make up for the shortfall. The SEC is in the process of reviewing several aspects of the marketplace, including conflict of interest, marketing practices and disclosure. Instances where funds lost substantial amounts include the Arkansas Teachers’ Pension Fund that, through a consultant, became involved with Andrew Fastow, Chief Financial Officer of Enron. Arkansas committed \$30 million to an investment in one of Enron’s off balance sheet entities and may have lost it all. Louisiana, a client of the same consultant, due to losses resulting from an allocation of 42% of assets to “alternative investments”, incurred an increase of \$147 million (more than 20%) in its appropriation to the fund. In 2002, Hawaii discovered that its consultant had recommended 16 money managers—14 of whom were paying that consultant for services.

PERAC Disclosure Forms now require that consultants and money managers reveal any arrangements in which compensation is paid for third party marketing services and related agreements. Boards must review these disclosures carefully in assessing the merits of a prospective manager or consultant. The goal of any disclosure rule must be to ensure that board decisions are based on knowledge of all the circumstances related to the vendor’s application to do business with the board.

Examples of Problems

- Some vendors have failed to file full disclosure of all third party arrangements.
- Arrangements that take place after the retirement board has contracted with a vendor are not disclosed.

Recommendation

We recommend requiring annual disclosures from managers, consultants and from third party marketing firms regarding all remuneration paid or received related to the fund managed for a retirement board. In addition, sanctions should be established for failing to file accurate statements.

The expansion of existing disclosure requirements relating to payments associated with obtaining business from a retirement board and enhanced penalties for failure to disclose would form an essential ingredient of the investment oversight process. The annual filing of disclosure forms and the delineation of all payments from or to any source would be components of the changes.

This process will enable the Commission to increase emphasis on competitive process and fiduciary compliance.

D. Procurement Reform

Judging from the ongoing questions about procurement that PERAC receives, boards do not possess a full understanding of the importance of competitive bidding and the need to negotiate contracts aggressively.

Examples of Problems

- Boards seek to invest in funds offered by managers that have been previously selected for other strategies.
- Boards are not aggressive in negotiating the terms and conditions of agreements with service providers.
- Boards retain vendors for long periods without entering the marketplace to ascertain if the vendor remains competitive with others.

Recommendation

We recommend that a procurement process similar to that required under Chapter 30B, the municipal procurement law, be established to govern the process by which retirement boards select certain vendors (investment, actuarial, legal and accounting). Details of these requirements should be developed with the assistance of the retirement boards and consultants.

E. Proxy Voting

Recent corporate scandals have underscored the importance of shareholder rights as a check on improper corporate behavior and as a tool to enhance investor value. Pension funds have generally not pursued shareholder rights through the primary mechanism for such action, proxy voting and shareholder resolutions. Basic principles of good corporate governance require that boards ensure that their shares are voted in a manner that is consistent with the interest of the retirement system and its members. Proxies are considered an asset of a system and a board has an obligation to exercise its fiduciary duties.

Examples of Problems

- Boards frequently rely on money managers to exercise proxy rights without providing guidance as to the position of the board.

Recommendation

We recommend that PERAC adopt regulations requiring each board to adopt a policy on proxy voting. That policy should set forth how the board will vote on various issues. Each board must follow its policy when it exercises its vote directly or it must instruct its consultants/managers to follow that policy if the manager or a consultant is responsible for voting.

2. ENFORCEMENT

Debarment, PERAC Disciplinary Authority and Increase in Penalties for Chapter 32/Regulatory Violations

A. Debarment

There is no current statutory authority enabling PERAC to prohibit an individual or firm that is guilty of violations of Chapter 32 or PERAC regulations or other violations from providing services to a board.

Examples of Problems

- There is no process for dealing with firms that are found to be in gross violation of SEC or other investment regulations. These include recent cases such as those related to market timing, late trading or providing certain customers preferred treatment.
- There are no implications for firms that have willfully filed erroneous or incomplete Disclosure Forms. In the past, vendors have failed to disclose third party payments properly; but PERAC had no authority to impose consequences for such failures.
- There is little way to discipline firms that seek either directly or through intermediaries to influence board decision-making. Recent events in Ohio and Milwaukee relating to trustees receiving gratuities from vendors have underscored the need for authority to respond in cases of undue influence.

Recommendation

We recommend that vendors be prohibited from doing business with systems if they have been convicted of a criminal offense or are in substantial non-compliance with procurement standards or other Chapter 32 provisions, PERAC regulations, or have committed similar offenses in relation to other pension funds and/or investors. We also recommend that firms be subject to sanction even if such violations did not directly involve Massachusetts pension funds.

We recommend that PERAC file legislation authorizing it to develop a range of enforcement options in the debarment area.

B. PERAC Disciplinary Authority

The existing statutory scheme provides no direct authority for the Commission to take swift remedial action when a system is being mismanaged, the rights of members are threatened, or other circumstances warrant.

There is a need for some form of intercession that, in conjunction with other reforms, will provide the Commission with far more effective tools to swiftly and directly stabilize and correct major problems in a board operation.

Examples of Problems

- In one system, there has been an incapacity to submit the statutorily-mandated Annual Financial Statements to PERAC for a period of several years.
- In another, the system attempted—against PERAC’s direction—to provide three separate benefits to a widow.
- Other systems are enmeshed in a controversy regarding whether contractual agreements between the locality and unions are consistent with the definition of “regular compensation” in Section 1 of Chapter 32 and consequently the salary that should be used in calculating retirement benefits.
- For more than two years, a system has refused to pay benefits that DALA and PERAC have instructed it to pay.

- In another system, there has been a refusal to reinstate a police officer who is on the payroll and on patrol but not officially accepted as a “member” of the system.
- In a large system, more than \$36 million was lost (roughly 8% of the portfolio).

Recommendation

We recommend that PERAC file legislation allowing it to issue orders to boards to take or desist from any action in order to insure that the system is managed with appropriate care, skill and diligence. Such an action would only take place after the Commission first determines that the board has failed to comply with law or regulation. The type of order contemplated by the proposal could include termination of contracts, approval/denial of retirement benefits, a directive to conduct a fiduciary audit, invalidating a previous action by the board, and transfer of some or all assets into the PRIT Fund for a specified period of time but no more than five (5) years.

We recommend that legislation provide that such Orders could only be appealed directly to Superior Court.

C. Increase in Penalties for Chapter 32/Regulatory Violations

It is important that the level of penalty for violations of Chapter 32 or PERAC regulations be significant enough to act as a deterrent. Present statutory penalties of \$1,000 or one year imprisonment, or both, have been in the law for many years. They do not recognize the changing nature of retirement board responsibilities, particularly as they relate to asset size and fiscal management. An increase in penalties will make it clear that violations of the law are serious offenses and can result in serious penalties.

Example

- A PERAC audit uncovered a situation where a city was manipulating the appropriation to the system and in effect “kiting” money. The case was not prosecuted, in part, due to the lack of sufficient penalties.

Recommendation

We recommend that PERAC file legislation to increase current penalties to \$10,000 or not more than two and one half years imprisonment or both, per violation of Chapter 32 or PERAC regulations.

3. CONFLICT OF INTEREST

Annual Board Member Certifications and Conflict of Interest

A. Annual Board Member Certifications

General corporate governance principles now require an annual certification by board members of the accuracy of the corporate financial statements. Similarly, it is necessary to ensure that retirement board members conduct an annual self-examination to determine whether the board has complied with its statutory and fiduciary duties.

Examples of Problems

- A fiduciary is aware of a breach of fiduciary duty by a co-fiduciary.
- A fiduciary is aware of improper acts by a co-fiduciary.
- A fiduciary has committed acts that violate state ethics law and the State Ethics Commission has made such a finding.

Recommendations

We recommend that PERAC file legislation mandating that board members make an annual certification filed with PERAC under pains and penalties of perjury that they are not aware of past or ongoing:

- Violations of Chapter 268A (Ethics Law);
- Violations of statute;
- Violations of regulation; and
- Violations of fiduciary responsibility.

B. Conflict Disclosure Forms

Retirement boards make determinations and exercise discretion involving large sums of money and benefits to be paid to individual members. The principles of good board governance suggest that board members should file an annual disclosure of conflicts or potential conflicts. The form would identify such items as sources of income, gifts, and honoraria/reimbursements. This is not unique to Massachusetts, as similar concerns have led to filing of such forms in other states. While most financial interests would not render a board member ineligible for participation in board decisions, disclosure can remove perceptions of conflict.

Examples of Problems

- Board members receiving honoraria for participation in conferences financed by investment vendors.
- Board members receiving compensation from individuals or firms doing business with the retirement boards.
- Board member family members providing services to retirement boards.

Recommendation

We recommend that PERAC file legislation mandating the filing of Conflict Disclosure Forms by retirement board members. PERAC would, through regulation, develop the form, require submission, review the forms, and initiate investigations if there was due cause to suspect a violation.

We also recommend that PERAC provide examples of potential conflicts to the board members in documentation accompanying the form and conduct educational seminars to inform board members of possible conflict situations.

4. BOARD STRUCTURE

Limits on Board Membership and Increase in Board Stipends

A. Limits on Retirement Board Membership

In addition to selecting vendors to provide services, retirement board members set the compensation for employees and make ultimate decisions on the expenditure of board assets. Principles of good governance suggest that board members should not be placed in a position of recusing themselves from important aspects of the board's operations—such as approval of the annual operating budget—because of direct financial benefit, or from making such determinations about fellow board members.

Examples of Problems

- A board member works for a firm that does business with managers that provide services to retirement boards—and the board informs the managers that, although that board member may not benefit from the manager's relationship with the board on which he serves, he may benefit from the manager's relationship with other boards.
- A board member represents a firm that provides money management services to other boards.
- A board member, who is also an employee of the retirement board, faces conflicts of interest in board discussions and decisions over employee performance and compensation.

Recommendation

We recommend that PERAC file legislation providing that no one receiving any remuneration of any kind from a retirement board or receiving remuneration from any firm doing business with a retirement board may serve on a retirement board.

Exceptions would be:

- a. Receiving a stipend for serving on a board;
- b. Receiving a retirement benefit;
- c. Staff may serve on a retirement board other than their own; and,
- d. Current members should be grandfathered.

B. Increase in Board Stipend

The fiduciary responsibilities attached to service of board members are considerable. Remuneration for the commitment of time and energy necessary to fulfill these responsibilities in an appropriate manner is desirable. It has been some time since the level of compensation has been adjusted. Local communities should have the ability to provide a stipend level that meets the level of commitment they expect from the retirement board members. Since adoption of any stipend by the city or town is optional, and the appropriate local authorities will decide the amount within the range, safeguards are in place to ensure that the level is appropriate for each city or town's unique circumstances.

Recommendation

It is recommended that PERAC file legislation to allow local communities or other authorizing bodies through local option acceptance to provide an annual stipend up to \$7,500 to their retirement board members.

5. EDUCATION

Best Practices Manual and Mandatory Education

A. Best Practices Manual

PERAC, as an oversight agency, is responsible not only for enforcement but also for compliance assistance. Compliance assistance encompasses not only measures to prevent violations of law or regulation but also educational assistance to ensure conformance with sound governance principles. PERAC is the proper authority to carry out this responsibility.

Retirement boards have a clear and ongoing need for information on how best to manage their operations, exercise their investment functions, and generally carry out their fiduciary responsibilities. Adoption of best practices is an effective way to assure that the board is operating in accordance with fiduciary duty.

Recommendation

We recommend that PERAC develop a Best Practices Manual that will serve as a management tool for boards in operations and investment practices.

B. Mandatory Board Education

There are currently no educational requirements for board members. In light of the changing nature of the responsibilities of board members and the need to maintain up to date knowledge of investment strategies and governance practices, education is the most effective way to achieve change.

Recommendation

We recommend that PERAC file legislation to mandate educational requirements for board members, since there is a clear need for education. This should be mandatory for all board members upon entering service within a time period prescribed in regulation by PERAC. Continuing education should also be mandatory.

ADVISORY COMMITTEE BIOGRAPHIES

Scott Harshbarger, *Chair*

Prior to joining Murphy, Hesse, Toomey & Lehane, LLP heading up the firm's governance practice, Scott Harshbarger's distinguished career in public service included experience as the national President and CEO of Common Cause, Attorney General of Massachusetts, and District Attorney of Middlesex County, among other positions of leadership.

As President and CEO of Common Cause, Mr. Harshbarger re-energized the nationally recognized, independent government and corporate watchdog group, working to push passage of the landmark federal campaign finance reform legislation, and expanding Common Cause's agenda to include election reform and its corporate governance initiative.

As a two-term Massachusetts Attorney General (1991-1999), Mr. Harshbarger won national recognition for his work in crime prevention, civil rights and hate crimes enforcement, elder protection, and prosecution of white-collar crime and public corruption. He was the first Attorney General in the nation to work with the health care community to develop hospital and HMO community benefit guidelines, and was one of the nation's first to sue the tobacco industry to help recover smoking-related health care costs. Mr. Harshbarger was the Democratic nominee for Governor of Massachusetts in 1998.

Before his election as Attorney General, Mr. Harshbarger was Middlesex County District Attorney for eight years. A graduate of Harvard College and Harvard Law School, Mr. Harshbarger taught legal ethics at Boston University Law School, and was a Visiting Professor at Harvard Law School and Northeastern Law School.

Cary Coglianese

Cary Coglianese is Associate Professor of Public Policy at Harvard University's John F. Kennedy School of Government and Chair of the Regulatory Policy Program at the School's Center for Business and Government. He has also been a visiting professor of law at Stanford University and the University of Pennsylvania. His interdisciplinary research focuses on issues of regulation and administrative law, with a particular emphasis on the empirical evaluation of alternative and innovative regulatory strategies and the role of disputing and negotiation in regulatory policy making. His work has appeared in, among other journals, the *Administrative Law Review*, *Duke Law Journal*, *Law & Society Review*, *Michigan Law Review*, *University of Pennsylvania Law Review*, and *Stanford Law Review*. He is the founder and co-chair of the Law & Society Association's international collaborative research network on regulatory governance, the vice-chair of the e-rule-making committee of the American Bar Association's Administrative and Regulatory Practice Section, and the vice-chair of the Committee on Innovation, Management Systems, and Trading of the American Bar Association's Section of Environment, Energy, and Resources. At the Kennedy School, Coglianese teaches public law, environmental law and policy, and regulatory strategy. He is a recipient of two Resources for the Future fellowships in regulatory implementation as well as the American Political Science Association's Edward S. Corwin Award for his research on environmental litigation. He received his J.D., M.P.P., and Ph.D. from the University of Michigan and is a member of the bar of the State of Michigan and the United States Supreme Court.

Paul M. Healy

Paul Healy joined Harvard Business School in 1997 and is currently the James R. Williston Professorship of Business Administration, and Head of the Accounting & Control unit. His primary teaching interests include financial reporting and analysis, corporate finance, and corporate governance.

Professor Healy received his B.C.A. Honors (1st Class) in Accounting and Finance from Victoria University, New Zealand in 1977, his M.S. in Economics from the University of Rochester in 1981, his Ph.D. in Business from the University of Rochester in 1983, and is a New Zealand ACA. Prior to joining Harvard, Professor Healy was on the faculty at the M.I.T. Sloan School of Management, where he

received awards for teaching excellence in 1991, 1992, and 1997. In 1993-94 he served as Deputy Dean at the Sloan School.

Professor Healy's research focuses on firms' disclosure and financial reporting strategies, corporate governance, mergers and acquisitions, corporate financing strategies, and managerial compensation. His work has been published in leading journals in accounting and finance. He is also the coauthor of the leading financial analysis and valuation textbook. His research awards include the AICPA/AAA Notable Contribution Award for outstanding contributions to research (in 1990 and 1998) and the AICPA/AAA's Wildman Medal for contributions to the practice (in 1997).

Alan G. Macdonald

Alan G. Macdonald is Executive Director of the Massachusetts Business Roundtable (MBR), an organization comprised of seventy-five leading executives of major Massachusetts enterprises. MBR focuses the management perspective of its members on statewide issues to help the Commonwealth's leaders design and implement policies for the benefit of the state's economy and for the improvement of the quality of life in Massachusetts.

Prior to coming to the Roundtable in January of 1989, Macdonald served for ten years as the Manager of State Government Relations for General Electric Company in Massachusetts and in other New England states. Prior to his work with GE, he was Manager of Government Relations and Public Affairs for Gulf Oil Corporation in New England, Pittsburgh and Washington, D. C.

From 1969 to 1975, Macdonald was an Assistant Attorney General for Massachusetts, working primarily in the areas of environmental law and criminal law enforcement.

Born in Cambridge, Massachusetts, Macdonald lives in Winchester with his wife, Jane. They have two sons, who live nearby and are pursuing their own careers in the Greater Boston area.

Macdonald is a Trustee of the Winchester Savings Bank; a Director of the

Massachusetts Business Development Corporation; and Chairman of the Board of Trustees of Hallmark Health Corporation, a community hospital in Medford, Melrose, Wakefield and Malden. He is twice past chairman of the Board of Selectmen in Winchester, past president of Winchester Country Club, and currently a Director of several non-profit organizations.

He is a graduate of Dartmouth College and Boston College Law School, and past president of the Dartmouth Alumni Association of Eastern Massachusetts.

Jerrold Mitchell

Jerrold Mitchell has worked in the investment business for over forty years, as a Wellington Management Company partner, Chief Investment Officer of the Massachusetts Pension Reserves Investment Management Board, and currently as Chief Investment Officer of The Boston Foundation. He is an Adjunct Professor at Brandeis University's International Business School and serves as a trustee of Century Shares Trust and several non-profit organizations. He is a graduate of Yale University, Harvard Law School and Harvard Divinity School. Mr. Mitchell lives in Wayland, Massachusetts.

